KPMG

Growth and Diversification in Islamic Finance

FINANCIAL SERVICES

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1 Introduction

The contemporary Islamic finance industry is now in its fourth decade and, during that period, has developed extremely rapidly. In the past few years, overall market growth has been estimated at between 15-20 percent annually[1], although individual Islamic banks have reported even faster growth. In 2006, for example, Arcapita Bank in Bahrain reported year-on-year balance sheet growth nearer to 40 percent. Today, the sector has estimated assets under management of US$500bn[2].

Market dynamism has been felt in both the traditional Islamic finance centers and a number of other markets. According to Bank Negara Malaysia (the Malaysian central bank), the number of Islamic bank branches in Malaysia increased from 126 in 2004 to 766 in 2005. Elsewhere, new Islamic financial institutions (IFIs) are being established rapidly in the industry's traditional markets in the Gulf Co-operation Council (GCC) countries.

Islamic finance is also on the rise in new markets such as Syria, Lebanon, the U.K., Turkey and Canada. In the U.K., for instance, two new Islamic banking licence applications are currently being considered by the Financial Services Authority (FSA), following the authorization in the past three years of the Islamic Bank of Britain and the European Islamic Investment Bank.

Further, the recently proposed changes to U.K. tax law should help to remove the tax disadvantage which U.K. Sukuk issuance would have previously suffered. U.K. Sukuk issuance is now looking like a valid financing option to be explored by businesses which want to be Shariah compliant as well as by other businesses which want to diversify their investor base or benefit from the ongoing infrastructure investments within the Middle east. More significantly these tax changes help to signify that Islamic finance can play an important role in western economies. The changes in the U.K. are very likely to be replicated in other countries thereby creating an enabling framework for the rapid global development of Islamic finance.

The prospects for Islamic finance have also encouraged some conventional banks to embark on the process of converting to Islamic financial institutions. Two years ago, for example, the Kuwait Real Estate Bank (KREB) announced that it was converting into a full-fledged Islamic bank. In December 2006, the Central Bank of Kuwait approved KREB's Islamic Banking license, complete with name change to Kuwait International Bank. "The future is very exciting," says Sulaiman Al-Baqsami, assistant general manager of KREB. "If we could convince our traditional client base, we could solicit potential customers with other conventional banks."

In the past five years, perceptions of the Islamic finance industry have advanced considerably. Originally, says Richard Thomas, managing director of Global Securities House U.K. Limited (GSH), a wholly-owned subsidiary of Securities House Group of Kuwait, the global financial services companies saw Islamic finance as a market for liquidity management and cheap short-term funding.

This perspective has changed. "They now see opportunities across the board from project finance to securities issuance," he explains. "Five years ago, they saw a one-dimensional market; now they see it as a multi-dimensional market complete with opportunities in fund, asset and wealth management. The result has been that more international banks are setting up Islamic finance teams and one would be hard-pressed now to find banks not having the capabilities to intermediate the market."

The purpose of this report is to explore current and future development of Islamic finance and to examine ways in which the sector is predicted to diversify and grow in the years ahead. KPMG International commissioned the Economist Intelligence Unit (EIU) to undertake a series of interviews in February 2007 with leading figures from the industry. Both the EIU and KPMG International would like to thank all respondents for their participation.

1, 2: Source: speech by Howard Davies, chairman of the Financial Services Authority
http://www.fsa.gov.uk/Pages/Library/Communication/Speeches/2002/sp103.shtml

2 Product and Market Diversification

As IFIs consolidate in their home and regional markets and venture into cross-border start-ups and exposures further afield, there is strengthening evidence for market diversification. The reason for this, explains Mr. Jaidah from QIB, "is to allow surplus liquidity in the Islamic market to be employed with different risk ratings; with different asset classes; and with different market exposures."

The general consensus within the industry is that some of the key areas for product innovation will be in the issuance and trading of asset-backed securities (Sukuk); project and infrastructure financing to include new markets outside traditional ones such as the West; structured finance derivatives; private equity; retail banking beyond the Islamic mortgage; and value added real estate products.

There is, however, some question as to how much product innovation is actually needed at the moment, given that the industry is relatively young and that many of its products are still nascent. Indeed, some practitioners stress that the market is as much in need of consolidation and refinement as it is of innovation and new products.

Duncan Smith, managing director and global head of Islamic finance at Arab Banking Corporation (ABC) in Bahrain, points out that, in the GCC and Malaysia, many of the retail needs of the market are probably being met. He does not see any shortage of products, although in Western markets such as the U.K. it will take longer to introduce a wider range of Islamic consumer finance products beyond the Islamic mortgage. Nonetheless, while incremental change—consolidation and product refinement—will remain central in the market's development over the short term, innovation will remain important.

Mr. Thomas of GSH believes that the main area for product diversification is Takaful (insurance). The Islamic insurance (Takaful) industry is potentially the most lucrative of the Islamic financial landscape, simply because insurance is a highly under-developed sector, especially in the conservative GCC countries. Even in Malaysia, market penetration of Takaful is proving to be an uphill struggle.

He is more cautious about the future for hedge funds. "They have been the next big thing in the Islamic finance space for years, and I have not actually seen one operating properly yet," he explains. Exchange traded funds (ETFs), similarly, have been slow to take off, despite the fact that two leading Islamic equity index providers, Dow Jones and FTSE, have been trying to promote them in the past two years. Currently, there is only one Shariah-compliant ETF, the DJIM Turkey Exchange Traded Fund, launched in Istanbul in January 2006 by Turkiye Finans (a merger between two Turkish Islamic banks), and based on the Dow Jones Islamic Market (DJIM) Turkey Index.

Barclays Capital and others are also in the process of launching an ETF off the FTSE-SGX Asia Shariah 100 Index, launched in January 2006 by FTSE and The Singapore Stock Exchange (SGX). Progress has been slow, however, because of the unfamiliarity of Islamic institutional investors with ETFs.

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Despite the real estate boom in the GCC and a warning from Standard & Poor's in a report that IFIs may be over-exposed to exposure to the real estate markets, bankers such as Peter Panayiotou, Deputy Chief Executive of Gulf Finance House (GFH) in Bahrain are convinced that analysts are reading the situation wrongly.

"Many people think the real estate boom is speculation," he asserts. "It isn't actually. It is catch-up. We've seen in the past three years, since the end of the Gulf War, a concentration of initiatives which were suspended during the inter-Gulf War period, with the exception of Dubai, which halfway through that period perked up and said 'We are going to ignore that and carry on'."

HSBC Amanah Case Study

HSBC Amanah has not hidden its light under a bushel. The Islamic finance division of the world's third-largest bank was set up in 1998 with the stated aim of becoming the global leader of the nascent sector. It has devoted significant resources to the task, hiring more than 100 dedicated staff - in addition to group-wide resources - across the Middle East, Europe, Asia-Pacific and the Americas.

Following an early focus on the Middle East, where most populations are predominantly Muslim, HSBC Amanah has now decided to expand into countries where Muslims are in a sizeable minority. The retail market in the U.K., which has a Muslim population of nearly 2m, was identified as having the right attributes to test the strategy. Amjid Ali, Chief Executive of HSBC Amanah in the U.K., says: "There is very stringent regulation in the U.K. so we thought if we could crack it here, we could succeed anywhere.

Mr. Ali, Senior Business Development Manager, had worked for the U.K.s Midland Bank, which was bought by HSBC in 1992, for 17 years before being appointed in 2003 as a business development manager for the newly launched Islamic finance division. He had encountered demand for Islamic finance as long ago as the1980s. "I ran a pilot program in Bristol in 1987 and many Muslims there said they wanted products in accordance with their faith," he explains.

In 2005, he was appointed chief executive with a brief to develop products in home finance, current accounts, pension funds, and buildings and content insurance. The initial target was the mortgage market. HSBC says Muslim families in the U.K. have taken out 134,000 conventional mortgages worth UK£9bn and there are a further 76,000 households with no mortgages at all. Mr Ali believes a large proportion of households that already have mortgages could switch to Islamic home finance. About 200,000 households in total match our target profile. These are mainly second-generation Muslims who have some knowledge of finance," he says.

So far, progress has been steady, if not spectacular. By mid-2006, HSBC Amanah had signed up 3,300 home finance customers, providing £370m in finance to them. In addition, more than 5,000 personal bank accounts had been opened.

In part, growth has been held back by the problem of convincing potential customers that products meet the demands of their faith. "Few people question Halal meat, but they don t necessarily accept Shariah-compliant products, explains Mr. Ali. Another issue is the higher cost of Islamic finance. Products cannot be imported wholesale from the Middle East division - they must be approved by an independent Shariah advisory board, pass regulatory tests and be adapted so that they fit on HSBC's U.K. product platform. The cost of this process is inevitably passed on to clients. "Most accept that there is a marginal cost for peace of mind," says Mr. Ali.

In the early stages, the bank's marketing activity consisted of explaining Islamic finance through highly targeted seminars, presentations and meetings with community leaders and scholars. This direct approach was supplemented by sponsorship of local groups and organizations. Mr. Ali believes that now is the right time to begin marketing in earnest. "We had to build a knowledge base and we feel that point has been reached," he says. This year, HSBC Amanah will run radio and TV campaigns, many channelled through Asian and Arab TV and radio stations.

Marketing can also take more subtle guises. HSBC Amanah recruits heavily from the Muslim community to build cultural knowledge at each branch. Mr. Ali says: "We employ people who want financial rewards but also want to help fellow Muslims.

Of course, creating a U.K. retail market for Islamic finance is not down to HSBC alone. Competitors such as Lloyds TSB and the Islamic Bank of Britain share the responsibility and, for now, there is a feeling of fraternity rather than rivalry between them. But as the market matures, competition is likely to intensify and, in readiness for this, HSBC Amanah is preparing to roll out new products in areas such as savings, student finance and the small business sector.

These plans depend, of course, on whether consumers buy into the concept. Mr. Ali is confident: "Thirty years ago, if you wanted Halal meat you slaughtered a live chicken. Now even Tesco sells Halal meat. Things change.

GFH, which is leading landmark Islamic real estate projects in India, Morocco, Jordan, Qatar and Bahrain, expects considerable opportunities for value-added Islamic real estate investments, especially in the GCC countries, where a young demography and robust year-on-year population growth should maintain demand for housing, shopping complexes and leisure facilities.

Mr. Panayiotou believes that the key product segments include asset management, wealth management, insurance, consumer finance, investment banking and private equity, but concedes that there is still much work to do in the sector. "Our investment banks need to roll into proper investment banks," he explains. "Most of them are focused on one line of business. There is a lot of room to grow; a lot of new products to develop. The derivatives industry alone is a huge business if we can crack the more complex structures beyond the vanilla products that don't breach Shariah rules. There is a whole new industry that sits on top and that is completely untapped."

Mr. Jaidah of QIB agrees that Shariah scholars have an important role to play in product innovation. "The bankers give the explanations and the clarifications regarding the basic format for the products. But, it is the scholars who have to understand the structure and the sophistication that is needed for these products to support the IFIs and to leverage their use," he says.

Many GCC-based Islamic bankers are aware that eventually they will have to be more creative in product innovation and diversification, especially in the area of exotics such as derivatives, swaps, options, Repos, ETFs, hedge funds and even Sukuk. But many of them doubt whether these products are the right ones for a market which is still at the lower end of a steep learning curve.

What happens if the oil price goes down?

Some economists stress that the real test for the Islamic finance market would be its ability to absorb shocks in an era of low oil prices and budget deficits. Many Islamic bankers, however, are bemused at suggestions of a negative impact on the sector, if the price of oil were to drop to a historical mean.

"Why would we have to focus on the Islamic finance sector if such a thing occurs?" asks Salah Jaidah, Chief Executive of Qatar Islamic Bank (QIB). "Such a scenario is going to affect the financial markets as a whole."

Bankers such as Mr. Jaidah stress that GCC governments have budgeted for various oil price scenarios. Many of the GCC states, for instance, have catered for a stabilization of the oil price to US$50 per barrel. Several Saudi economists predict that the average

US$50 per barrel scenario is the most likely for the next few years. “If the price of crude oil drops below US$18 per barrel, then everyone will be in a chaos, let alone the banks,” adds Mr. Jaidah.

Low oil price scenarios are not new. In fact, several Islamic bankers interviewed stressed that the sector did go through oil price downturns in the1980s, 1990s and early 2000s, and it successfully weathered the storm. “At QIB, we have seen the ups and downs of oil prices, and we managed our portfolios. We have short, medium and long-term maturities,” explains Mr. Jaidah. “We also have different resources we can utilize such as inter-bank and Murabaha liquidity management lines. We could support any immediate needs or run on deposits that occur in the market.”

Mr. Thomas of GSH concurs that a slump in oil prices is not going to affect the Islamic finance market materially. He is more concerned about the impact on asset quality and their ability to comply with the capital and risk management provisions of Basel II.

“There is so much cash around even if the oil price goes down,” he explains. “The key is the asset quality of the portfolios of the Islamic financial institutions (IFIs), and that they remain robust. It would be much harder to deal with credit problems than with liquidity problems. There will always be liquidity. The question remains on the liability side, whether the assets are rated or not.”

Sukuk Proliferation

Sukuk—the Islamic finance world’s equivalent of a traditional bond—has taken the Islamic finance industry by storm over the past two years, with most of the origination in Malaysia and the GCC countries. In 2006, some 80 percent of the burgeoning GCC bond market was accounted for by Sukuk, up from just 26 percent in 2005, according to City law firm Towers & Hamlins.

The global Sukuk market is still relatively small – the estimated volume of outstanding Islamic securities (including Malaysian issuances) totaled just some US$70bn at the end of 2006, according to Business Times, Malaysia. The market has thus far been dominated by Malaysia. Saudi Arabia currently has only four Sukuk issuances to date, although Bryan Kraty, acting general manager of Gulf Islamic Clearing Company (GICC) in Bahrain, predicts that, in the future, some 90 percent of the Sukuk issuances will originate from

the Kingdom. "The biggest market for opportunities has to be Saudi Arabia," he explains. Other GCC markets are also starting to catch up. Dubai Islamic Bank and Abu Dhabi Islamic Bank, for example, have respectively launched US$10bn and US$5bn Sukuk programs.

Thus far, there have been only two Sukuk originations in traditional western markets—the Saxony-Anhalt Sukuk in Germany, and the East Cameron Partners Sukuk in the U.S.. Nevertheless, there is significant potential for Sukuk origination in these markets, and in Europe in particular. Mr. Thomas of GSH projects that Sukuk origination and issuance by European corporates and governments "will be the next big step forward" in the market, with the U.K. leading the initiative.

Ed Balls, the Economic Secretary to the U.K. Treasury, confirmed in February 2007 that the Treasury is currently looking at how the U.K. tax system interacts with the Sukuk market; the barriers to establishing a secondary Sukuk market in the U.K.; barriers in the way of U.K. origination and issuance; and taxing of U.K. Sukuk certificate holders. Market players are keen for the U.K. to issue a benchmark debut sovereign Sukuk and to spearhead the development of a "Euro-Sukuk" market dominated by U.K. and EU corporate issuances. Many IFIs privately stress that sovereign issuances above US$250m by highly rated countries may be needed as liquidity management instruments by banks.

The U.S. and Europe are not the only global markets entering the sector. Reports in the Middle East Economic Digest and elsewhere suggest that the Japanese government is preparing a debut sovereign Sukuk issuance of over US$500m in 2007. Indonesia, Turkey and Saudi Arabia are also contemplating debut sovereign benchmark issues.

To Badlisyah Abdul Ghani, head of Islamic finance at Malaysia's CIMB Group and Chief Executive of CIMB Islamic Bank, more issuance will be one of the keys to the growth of a global Islamic capital market. "The development of a global Islamic market has been slow because people are unwilling to take the necessary steps," he says. "The more players that arrange issuance in the market, the better. You cannot have an active secondary market until you have well in excess of 100 issuances."

Research done by GICC suggests that the tipping point would be when the market attains a US$400bn pool comprised of about 270 issuances. "By that time you will have enough instruments and people will start taking off-the-shelf products and start trading. The truth is that there are not enough alternative Islamic investment instruments to further stimulate trading," says Mr. Kraty.

Mr. Panayiotou of GFH agrees that more work needs to be done to stimulate a secondary trading. "If there was a secondary market we would feel more comfortable," he explains. "If the people who buy the Sukuk have no way to sell them apart from holding them to maturity, there is not much incentive to buy the certificates. To be a market maker you need an institution with a very strong balance sheet, and the institutions with that sort of balance sheet are not really in our [Islamic finance] industry."

He goes on to express surprise that the major global banks have not been quicker to enter the Sukuk market. "The Islamic finance sector has actually given them a new line of business," he explains. "I don't understand why they have not jumped in."

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Unicorn Case Study

To date, no Islamic investment bank has developed a brand with truly global reach. Some have made significant inroads but sometimes encounter resistance from Muslim businesses and investors who do not wish to deal with western banks.

Unicorn Investment Bank was set up in an attempt to fill the void. Its founder and Chief Executive, Majid Al Sayed Bader Al-Refai, believes he has the background and industry experience to create a dominant Islamic brand. Mr. Al-Refai comes from a distinguished Kuwaiti family, was brought up and educated in the U.S. and learned his early banking in Saudi Arabia. He set up Unicorn in 2004 with US$113m of his own and friends money and with advisory support from UBS Warburg, a global investment bank. A further US$113m was raised from high net worth investors in the middle of 2006.

Mr. Al-Refai says the rationale for launching the bank needs little explanation. Asking me why we set up is like asking why we should breathe. It's because there are 1.5bn Muslims in the world and they don t have choice and they don t have service." He says that about 35 percent of Muslims have always avoided all forms of all interest-bearing investments and have had little choice other than to "put their savings under their mattress". With a further estimated 30 percent of "moderate Muslims also potentially open to Islamic finance, Unicorn has a potential universe of 975m people and all the businesses they own and manage.

Cultural reasons explain why an independent Islamic investment bank of scale has not yet emerged, says Mr. Al-Refai. Arabs are traders by nature. The concept of a global institution is just not in their blood. To achieve global reach, Mr. Al-Refai decided to domicile Unicorn in Bahrain rather than in his native Kuwait. "Bahrain is cosmopolitan and has been a banking center for 30 years," he explains. "It has strong relationships around the world, including with the Bank of England. It is a strict financial jurisdiction but friendly at the same time." In a short period, Unicorn has made strides to expand internationally. It now has a U.S. office, as well as a presence in Dubai, Kuwait and Malaysia. In January, it acquired a 75 percent stake in a Turkish brokerage.

Whereas many Middle East state-controlled banks have limited business lines, usually participating in property related deals, Mr. Al-Refai has created a sophisticated model, based on the activities of U.S. "bulge bracket" banks. Unicorn s six business lines are: corporate finance and advisory; capital markets and treasury; global private equity; asset management; strategic mergers and acquisitions; and takaful, or insurance. In each, Unicorn s competitive advantage is both challenged by the constraints imposed by Shariah law and enhanced by its access to Islamic businesses that are off-limits to many western banks.

the biggest market for opportunities has to be Saudi Arabia

For example, rare access to Muslim-run private companies has allowed Unicorn to arrange the largest ever private bond sale in Saudi Arabia, which closed in February at US$600m. On the other hand, it is not yet able to launch fully-fledged hedge funds. Instead it has created balanced investment funds using a mixture of equities and bonds. It believes this kind of innovation will attract high net worth investors who may otherwise head for the Swiss private banks. "I've never met a billionaire who told me he was satisfied with Islamic services, says Mr. Al-Refai.

But to win high-margin business requires high-caliber bankers who might otherwise work at western investment banks. Unicorn also has to compete for talent with state-owned regional banks, such as Dubai Islamic Bank, Abu Dhabi Islamic Bank and the UAE Emirates Islamic Bank. "Unlike others in the region," says Mr. Al-Refai, "we have put in place international pay standards. At the same time, he does not employ bankers for their specialist knowledge of Shariah finance. "We just want expert bankers," he says. "Few people have Shariah expertise and, in any case, we have a whole department to structure deals.

In 2006, Unicorn made a net profit of US$30m but it is considering a stock market flotation, possibly next year, to grow at a faster rate. "We will likely seek a listing in Bahrain first and then on the Alternative Investment Market after that," says Mr. Al-Refai. The proceeds would enable Unicorn to acquire more businesses and also grow organically by, for example, launching new private equity funds.

After the investment banking product range is filled out, Mr. Al-Refai plans to tackle the consumer market. At some stage we will have retail branches around the world," he says.

3 Barriers to Growth

the current lack of qualified Islamic bankers looks set to hamper the development of the sector should it not be addressed

The prospects for the growth of Islamic finance look bright. Nonetheless, there are several obstacles currently preventing faster uptake of Islamic financial products. These include the issue of regulatory capital and relative risk weightings under Basel II and the Islamic Financial Services Board (IFSB) guidance; a lack of human capital; piecemeal financial and legal architecture; weaknesses in financial reporting and transparency; and the overarching problem of a lack of Shariah convergence.

Risk weighting

In 2006, the IFSB issued two standards – the Capital Adequacy Standard (CAS) and the Guiding Principles of Risk Management for Institutions offering Islamic Financial Services. CAS offers guidance on the requirements for minimum capital adequacy to cover for credit, market and operational risks of IFIs that is equivalent to the Basel II Capital framework for conventional banking institutions.

According to the IFSB, the key difference between CAS and Basel II provisions is the computation of an institution's risk-weighted capital ratio (RWCR). In Islamic banking, given that the risks on assets financed by profit-sharing investment account holders do not represent risk to the capital of the institution, the CAS allows risk-weighted assets that are funded by the account holders to be deducted from the institution's total risk-weighted assets in the calculation of RWCR. In addition, the assets of IFIs often have different risk characteristics to conventional products, and hence calculating their risk weights may not necessarily be as straightforward as the Basel II proposals. It is the intention of the IFSB to bridge this gap.

To ABC's Mr. Smith, the process of calculating regulatory capital and relative risk weightings under Basel II is very important for the Islamic banking industry. "The Islamic finance industry is no longer the small or insignificant movement of say ten years ago. It has moved a long way. There are responsibilities in being a bigger part of the world financial movement. Calculation of regulatory capital and relative risk weightings under Basel II are some of them," he explains.

Human capital

Human capital development is crucial, as the current lack of qualified young Islamic bankers looks set to hamper the development of the sector should it not be addressed. In part, this low investment in the industry stems from the fact that the sector lacks a global industry body to oversee standardization of continuous education and training.

The lack of human capital in the sector affects all regions, including nascent markets such as the U.K.. Training of Islamic bankers has not kept pace with the rapid growth of the sector and, as a result, there are shortages throughout the industry.

The two centers for training have been KFH and Bank Islam Malaysia, which between them have been responsible for training many Islamic bankers. But high turnover remains a problem. "They come, they learn and they leave for better prospects," says Mr. Al-Ghannam of KFH.

There is some progress being made—in particular, Malaysia and Bahrain are taking the human capital challenge seriously. In 2006, for example, Bank Negara set up an RM500m endowment fund to support The International Centre for Education in Islamic Finance (INCEIF), with the main objectives of making Malaysia the leading center for Islamic finance education and developing human capital for the global Islamic finance industry. Similarly in 2006, The Central Bank of Bahrain set up a US$4.6m Islamic Finance Education scheme in cooperation with eight IFIs based in Bahrain.

Regulation and legal frameworks

While rising demand for Islamic finance has helped lead to handsome returns for key players, some experts in the industry are concerned that the rapid proliferation of IFIs has not been matched by development in the Islamic finance regulatory and supervisory architecture and infrastructure, especially in the GCC states.

"One thing that worries me," explains Ali Al-Ghannam, Head of International Real Estate at Kuwait Finance House (KFH), "is that the IFIs should be controlled better to avoid any bubble in the industry. There are a huge number of new IFIs being established in the market. Many banks and traditional companies are converting to Islamic finance. Islamic banking windows at global majors are proliferating. Many of these institutions are not going after the concept itself, but are following the flow of money."

Professor Rifaat Abdel Karim, secretary general of the IFSB, also agrees that systemic weaknesses present a big risk. "Muslim member countries need to beef up their financial systems," he explains. "If you are going to have Islamic banks operating in your system, one of the most important issues is to have a high quality regulatory framework and good supervisory standards. That is the safety net. It is good for market players to know what is required from them. There is still a lot to be done given the growth and developments that are taking place in the global Islamic finance industry."

Many Muslim countries still do not have enabling legislation in place covering the authorization of Islamic banks; issuance of Sukuk and securitization; establishment of trusts and special purpose vehicles (SPVs); the introduction of Takaful (Islamic insurance) products, and other such issues. Additionally, and of equal concern, many countries have not yet considered putting it on the agenda. Changing the law or introducing enabling legislation takes a lot of persuasion and time, says one Islamic banker interviewed. In fact, the U.K. has to date introduced more enabling legislation to facilitate access for U.K. Muslims and others interested in Islamic ethical finance to products consistent with Islamic principles than most of the Islamic Development Bank (IDB) member countries.

rising demand for Islamic finance has led to handsome returns for key players

changing the law or introducing enabling legislation takes a lot of persuasion and time, says one Islamic banker

we need to develop legislation on trusts; leasing; and SPVs

Some notable issues include the lack of a dedicated Islamic banking law in Saudi Arabia; few laws relating to corporate governance in many MENA countries; the lack of Islamic deposit insurance schemes (only Malaysia and Turkey have such schemes in place); and a dearth of laws governing securitization, trusts and SPVs.

Issam Al-Tawari, CEO of Rasameel Structured Finance—the first company in Kuwait to be licensed to carry out asset securitization (Tawreeq), financial engineering and advisory—stresses the need for stronger regulatory infrastructure. "We need to develop legislation on trusts; leasing; and SPVs – both to facilitate Sukuk issuances and the development of a capital market in Kuwait," he explains.

In this regard, the IFSB has started to establish prudential regulations to govern the IFIs. Beside the CAS and risk management guidelines for IFIs, the IFSB has released prudential regulations on corporate governance and an exposure draft on disclosure and transparency. These prudential regulations should now be considered and adopted by the various countries offering Islamic finance.

Financial reporting

The quality and transparency of financial reporting and disclosure in the Islamic finance industry differs significantly from one regulatory jurisdiction to another. There is a general concern in the market and among those interviewed that IFIs, with the notable exceptions of those operating in the U.K., Malaysia, Bahrain and perhaps Turkey, should have more rigor in their disclosure and financial reporting, especially to the general market.

The international rating agency Standard & Poor's, in a report last year entitled '*Enhancing Financial Reporting and Transparency: Keys to the Future of Islamic Finance*', warned that financial disclosure practices among IFIs fall well short of international best practice. "Standardisation of financial reporting is a key challenge for the rapidly growing Islamic finance industry," said the report, "in order to avoid fragmentation and ultimate ghettoisation at a time when Shariah-compliant investment vehicles as an asset class are coming of age."

The International Financial Reporting Standards (IFRS) constitute the main reporting framework for IFIs, but domestic regulation has also encouraged heterogeneity over uniformity. Frameworks in place in the leading IFI countries include IFRS, AAOIFI (Accounting and Auditing Organisation for Islamic Financial Institutions); Malaysian Accounting Standards; and some local GAAPs which are influenced by a combination of IFRS, AAOIFI and local central bank reporting guidelines.

Women in Islamic Finance

Islamic finance, like conventional financial services, remains a largely male-dominated industry. A woman has yet to be appointed as chief executive of an Islamic bank anywhere, even though several women have excelled in the industry.

Empowering women in the sector will largely depend on the existing role of women in a particular country or economy – a role that ranges widely across different markets.

In Saudi Arabia, for instance, says Samra al-Kuwaiz, managing director of the Womens Division of Osool Brokerage Company in Jeddah: "We live in a male-dominated society, which is only now viewing women as a possible economic force. Saudi Arabia is a special case. We are different from other GCC countries. We have complete segregation. We have let's say, 'Islamic challenges, which are more evident in the Kingdom.

The difficult position women face in Saudi Arabia is exemplified in the case of Dr. Nahed Taher, former chief economist of The National Commercial Bank (NCB), one of the largest banks in Saudi Arabia. She spearheaded the conversion of NCB's retail banking business to an Islamic consumer finance business—a process which is still ongoing—but left the bank to be appointed chief executive officer of First Gulf Bank in Bahrain, a position that would not be possible for a woman in her native Saudi Arabia.

There is, however, little doubt that women have huge financial impact in the Kingdom and the other GCC countries. Women, for instance, own between 10 percent - 30 percent of brokerage accounts in Saudi Arabia. They also own some 40 percent of family-run companies, often as silent partners. They have some SR10bn in deposits in banks and financial institutions[3].

In the rest of the GCC, despite fewer formal restrictions on women in the workplace, very few women are involved in the Islamic finance sector, this may, in part, be due to a strong conservative undercurrent in these societies.

In many respects, it is Malaysian women who have set the pace in Islamic finance. But even in Malaysia, while women head the authorities that regulate Islamic finance and capital markets, no Malaysian woman has risen to head an Islamic bank.

Dr. Zeti Akhtar Aziz is the celebrated Governor of Bank Negara Malaysia (the Malaysian central bank) under whose watch the Islamic banking sector has flourished, and who brought forward the liberalization of the Malaysian Islamic banking market by three years by awarding licenses to three foreign operators: Alrajhi Bank; Kuwait Finance House; and Asia Finance Bank. Similarly, Dato Zarinah Anwar is the Chairman of the Securities Commission, having previously worked for the RHB Group, where she was responsible for introducing the Dow Jones RHB Islamic Equity Index in 2006.

Several non-Muslim women are also seasoned Islamic bankers. One of the most experienced is Stella Cox, managing director and head of Islamic finance at Dawnay Day CAP, the London-based Islamic finance commodity and intermediation entity, whose Islamic commodity finance book business is in excess of US$3bn. As the market for Islamic finance becomes more established in non-Muslim countries, including the U.K., the role of women in the sector will undoubtedly become stronger, and the experience gained by women in the U.K. and elsewhere will be exported to other countries.

Women are also coming to the fore in the Islamic finance departments of international law firms, rating agencies and advisory firms. Currently, women are also working in senior positions in the Islamic banking sectors in Brunei, South Africa and the U.K..

Malaysia has gone one step further in an area that has been virtually closed to women elsewhere. Dr. Eg Rabiah Adawiah Binti Engku Ali, an academic at the International Islamic University of Malaysia, is the first registered female Islamic finance Shariah advisor, a development that could change the face of the Shariah advisory business over the next decade.

The rising involvement of women in Islamic finance has some potential to play a role in tackling the human resources bottleneck in Islamic finance. However, for this to happen, many Muslim countries would have to introduce enabling legislation guaranteeing gender equality and equal opportunities in the workplace.

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There is also a straight business case for an increasing role for women in Islamic finance: they can unlock major new market segments for Islamic banks. The emergence of the Sukuk, according to Ms. al-Kuwaiz represents a significant market opportunity. "Women are risk averse," she suggests. "The best kind of investment opportunity for them would be a diversified portfolio based on bonds, Sukuk, equities and real estate.

3: Sources : MENA FN (http://www.menafn.com/qn_news_story_s.asp?StoryId=1093146765)
Jeddah Chamber of Commerce and Industry

AAOIFI, with its voluntary adoption ethic, faces a challenge to convince the IFI countries. Of the 56 member countries of the Islamic Development Bank, for instance, fewer than ten have adopted the AAOIFI framework. Clearly more effort is needed to promote convergence on this front.

Each convention has its pros and cons. While much good work has gone into producing the AAOIFI standards, it is highly unlikely, according to several Islamic bankers interviewed for this study, that Europe would adopt these standards. In well-regulated markets, such as the U.K., people do not talk about Islamic financial products but alternative investment products. As such, say some Islamic bankers, talk about adopting AAOIFI standards could simply create more confusion in the U.K. market. Nevertheless, they agree that the value of AAOIFI is for regulators to have a reference point for better understanding risk.

Mr. Smith of ABC argues that the main issue is that one standard is adopted in a particular market. "It's horses for courses," he explains, "as long as there is some recognized standard that people can conform to. In Bahrain it happens to be AAOIFI. They do a good job. I say go for AAOIFI."

Part of the issue with lack of standardization of accounting standards is the variation between products offered by different IFIs. For example, a mortgage product could be structured differently from one IFI to another, which could give rise to a different accounting treatment. Hence, a broader approach to establishing accounting standards needs to be considered for Islamic finance.

Shariah Convergence

There are significant differences in the Shariah interpretation of Fiqh Al-Muamalat (Islamic law relating to financial transactions). This can apply not only to products, but also to operations and systems, because compliance can depend on certain processes being undertaken. These can cause problems, but it is important to remember that while harmonization of contracts, documentation and standards is a desired objective, equally diversity in Shariah opinions (Fatwas) is enshrined in Islamic legal history, and will thus remain a feature of the market by definition.

The lack of Shariah convergence is not only a phenomenon between Malaysia and the GCC countries. It also applies within the GCC markets. Much work has been done to bridge the gap between Malaysia and the GCC countries and to promote greater Shariah convergence in general. But such efforts have probably reached their limits. The Islamic finance industry would be wise, in the words of one banker interviewed, "to live and come to terms with this scenario."

KFH's Mr. Ali Al-Ghannam welcomes greater convergence but doubts that it is achievable in the short term. He comments that "Shariah scholars do not always communicate clearly with each other. It is this and not the [theological] differences that is creating the variances. Our scholars also lack a background in finance, and most also have a language barrier. This is a huge challenge for the industry."

For institutions in the West, issues of Shariah convergence are an issue, although not one that should be overplayed. In general, bankers in non-traditional markets such as the U.K. tend to side with the GCC model, simply because this is where the greatest liquidity resides.

Measuring Performance

Given all these complexities, the process of measuring the performance of Islamic financial products can be tough. Nonetheless, Basel II demands that banks allocate risk by rating, meaning that the rating of IFIs and instruments such as Sukuk will grow significantly in importance over the next few years. Whether setting the margin in a transaction or the pricing for commercial paper, lending institutions and institutional investors will scrutinize balance sheets and corporate structures.

Ratings for bonds and Sukuk, especially sovereign issuances, are important to set a benchmark for individual institutions' pricing of a specific instrument. However, the major western rating agencies, such as Standard & Poor's, Moody's and Fitch, have been slow to adapt their processes and frameworks relative to the rapid rise of the Islamic finance world.

"[The Islamic finance sector needs] a tailor-made rating agency to rate the performance of IFIs using a methodology and nomenclature that is consistent with the specificities of Islamic finance," says Mr. Al-Ghannam of KFH. "The measurement of performance differs even though the start and end result of Islamic finance is the same as conventional financing. However, in the middle, there is a huge difference." It remains to be seen whether the nascent International Islamic Rating Agency (IIRA), set up inter alia by the Islamic Development Bank, can assume this role.

The Western rating agencies have so far declined to develop a specific rating methodology and criteria for IFIs and instruments based on their unique Shariah-compliant structures, arguing that their current methodology and criteria for rating conventional institutions and instruments suffice.

To fill this gap, in Malaysia both the Rating Agency of Malaysia (RAM) and the Malaysian Rating Corporation (MARC) have pioneered new methodologies and criteria specifically for rating IFIs and instruments such as securities.

Nevertheless, institutions such as KFH are prepared to give the Western rating agencies the benefit of the doubt, stressing that performance measurement is a two-way education process, and that the Western agencies "are learning just as much from us".

The Role of Advisory Organizations

There is a broad understanding within the Islamic finance sector of the need for advisory organizations in the Islamic finance industry. Such organizations can provide assistance with a range of issues including tax, regulatory compliance, risk procedures, reporting issues and addressing shortages in human capital. The consensus, however, is that advisory organizations need to be well resourced, and have a clear separation of advisory and auditing services should the company offer both.

Advisory organizations, according to Mr. Thomas, can help offset the human resources bottleneck in the industry, and complement research and development (R&D) especially in structuring and policy initiatives. The banks themselves, he says, simply do not have the time for long, drawn-out processes because they must make money to justify such an allocation of resources.

Practitioners stress that advisory organizations have themselves learned much from the experience of IFIs. Over the past three decades, many of the primary Islamic finance tools such as Murabaha, Mudaraba and Ijara were explored and reworked through the process of collaboration between the banks, advisory organizations and law firms.

Mr. Smith of ABC, however, warns that from the industry point of view, only a few of the largest advisory organizations are "resourced for this kind of activity on a global scale. Nonetheless, he agrees that retaining a leading advisory or consultancy organization is essential for IFIs that are contemplating entering new markets, given the resources and expertise that these organizations can bring.

4 Conclusion

The Islamic finance industry is here to stay. In the space of three decades it has transformed from a peripheral activity to a sizeable alternative financial management system. Compared to the conventional financial system, it is relatively young. Industry practitioners are constantly learning from the experience of the conventional system, but the learning curve remains steep.

There is a real potential for expansion in retail banking and consumer finance, especially in populous Muslim countries. Non-traditional markets are also expected to become increasingly important, as is the provision of Islamic financial products to non-Muslim customers. The challenge here is to achieve a suitable level of support from the governments and regulators in these markets towards the sector.

The growth and diversification of Islamic finance, along with the geopolitical environment in which it operates, means that it would be unthinkable for the global Islamic finance industry "to go it alone". Institutions such as the U.S. Treasury, the U.K. Treasury, the International Monetary Fund, the World Bank, and the Basel Committee of the Bank of International Settlements, are all engaging with the sector in an attempt to "demystify" it and to promote global and industry best practice through the introduction of universal prudential and supervision standards. In addition, with many global banking majors entering the market, there is a real impetus in the West to promote the orderly development of the sector.

Muslim countries also want Islamic finance to be part of the global financial system, and are keen to adopt many of the more innovative practices and products as long as they comply with the principles of Fiqh Al-Muamalat (Islamic law relating to financial transactions). On these principles there can be no compromise, otherwise the very ethos and raison d'etre of faith-based Islamic financial management would be undermined.

As such, regulators such as Dr. Zeti Akhtar Aziz, Governor of Bank Negara Malaysia, see much greater convergence of Islamic finance with the global financial system as a niche alternative financing sector.

Muslim countries themselves, however, should seek to address their Islamic financial architecture. They need to establish which model they would prefer to follow – the dual banking model as in Malaysia where the Islamic system operates side-by-side with the conventional system, cooperating but not interacting; or the Islamization of the banking system as in Iran, Pakistan and Sudan.

The latter has to a large extent been discredited because of the fundamental anomalies that persist, especially in dealing with the correspondent banking relations of the Islamic banks. Sudan, Iran and Pakistan have all introduced exceptions to the rule allowing Islamic banks to engage in interest-based banking to accommodate these relationships out of necessity.

Conversely, many GCC countries effectively follow a de facto dual banking model, which many bankers including those interviewed stress is the model to emulate.

As Islamic finance continues its expansion and diversification into new markets and products, there is a real impetus to understand more clearly how it can fit into the global banking sector. As our interviewees indicate, there is a strong appetite for growth and diversification both among regional Islamic banks and global majors. At present, however, there remain a number of barriers to overcome, including human capital shortages, differences in Shariah interpretation, and a lack of consistency in financial reporting. While the prospects for growth and diversification look good, it appears there is still much work to be done to fulfil the core ambitions of the sector.